C.D. Howe Institute
Commentary

April 2002

The Border Papers

Shaping the Future of the North American Economic Space

A Framework for Action

Wendy Dobson

In this issue...

Why Canada should initiate a joint strategy for achieving a common goal of North American security.

The Study in Brief

Canada faces challenges to its living standards and economic position that the events of September 11, 2001, exacerbated. Although made-in-Canada efforts are required to improve our productivity performance, access to the US market is essential but less assured than it was. Paradoxically, a window of opportunity is now open because of the United States' current openness to its friends and neighbors. Canada should decide how to take advantage of this opportunity.

With power so dispersed in the US political system and with the Bush administration's exclusive focus on homeland security and defense, only a Big Idea will succeed, one that addresses US objectives while creating new economic opportunities for Canada.

This *Commentary* explores three such ideas — each of which would be a step toward removing remaining bilateral economic barriers. One idea is a *customs union*, which could be created by adopting a common tariff or a common external trade policy toward the rest of the world, allowing free circulation of goods and services within the common area. A second idea is a *common market*, which would free up the movement of people and flows of capital and technology, and common institutions could administer common standards, regulations, and policies that must be harmonized throughout the economic space.

The third idea is a pragmatic *strategic bargain* that Canada would initiate to achieve its objectives. Canadian initiatives would be required in areas of interest to the United States, specifically border security, immigration, and defense. Energy security is another key area where Canada should build on its existing strengths. In exchange for these initiatives, Canada should seek customs-union- and common- market-like arrangements that achieve deeper integration but recognize deep attachments to political independence and distinctive national institutions.

As part of the package, Canada should seek to eliminate troublesome barriers to people, trade, and foreign direct investment. Negotiations would be needed to curb US trade remedy laws that continue to harass softwood lumber producers; strengthen dispute settlement mechanisms; and develop the much-delayed common competition policy needed for industries that support growing North American production networks.

The Author of This Issue

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The Border Papers

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From time to time, unexpected events cause us to change the ways we think about the world, prompting us to reframe existing issues and perceptions of what is possible. In 1989, the fall of the Berlin Wall and the redrawing of borders accelerated the pace of global integration. In 2001, the horrific hijackings of September 11 demonstrated that the openness necessary for economic integration is also its greatest source of vulnerability.

Canada is one of the world's significant beneficiaries of economic openness. Historically, inflows of foreign capital financed its infrastructure and developed its industries; trade has long been a significant source of income. We are now deeply integrated with our large neighbor to the south through market forces and through policies of openness, such as those reflected in the Canada-US Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA). It is in our interest to reduce the associated vulnerabilities.

In the aftermath of September 11, US preoccupations have shifted to heightened security, which, if the border again becomes a major barrier, could undermine Canada's economic prospects. Some may argue that US concerns about homeland and military security are not our problem. This response is unfortunate. Although Canada is less likely than the United States to be a target, reinforcing North American self-protection and being seen to do so is in the Canadian interest.

Today, even more than in the past, removing barriers to deeper bilateral integration should be high on Canada's list of interests. The 1990s revealed significant weaknesses in our economy. Canada's standard of living has lagged that of its US neighbor (Fortin 1999); its real exchange rate has declined for reasons associated with relative economic weakness (Courchene and Harris 1999); and its share of the foreign direct investment (FDI) headed for North America has declined (Safarian and Hejazi 2001).

Simultaneously, rapid changes in the world — the emergence of new competitors in global markets, the revolution in information and communications technology (ICT), the increasing shift to knowledge-based goods and services industries — are changing patterns of economic activity around the globe.

As Canada faces these challenges to its standard of living and economic position in the world economy, easy and assured access to the US market is essential. Mintz (2001b) points out that we must be astute in creating the right economic environment to attract people and capital, and doing so by developing the Canadian advantage, not just by imitating what others do. To leverage our location next door to the world's leading and largest economy, we must reduce the impediments to flows of people and capital as well as goods and services.

This *Commentary*, the first in a special C.D. Howe Institute series called "The Border Papers," focuses on deeper integration (see Box 1 for more information on the series). The thesis of my overview is that Canada should initiate a joint strategy for achieving a common goal of North American physical and economic security.

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Box 1: *The Border Papers*

"The Border Papers" is a special *C.D. Howe Institute Commentary* series examining specific policy challenges Canada faces as it moves toward deeper Western Hemispheric integration, beginning with the United States. The purpose of the series is to discuss how Canada, the United States, and perhaps Mexico can achieve greater physical and economic security without loss of sovereignty and the erosion of the distinctive political and cultural institutions the people of each country hold dear.

The scope of the series will be wide-ranging and will cover numerous issues. The current paper provides a framework for the overall series; other papers will examine such policy areas as border issues, mechanisms for resolving trade and investment disputes, the exchange rate regime, energy, immigration, labor mobility, taxes, and defense policy. The series will conclude with a capstone paper. Each paper will examine the available options and offer policy recommendations.

I begin with an examination of three factors that affect Canada's choices. I then survey Canada's interests, which are mainly economic, and US interests, which mainly involve security imperatives. Finally, I discuss three policy options for advancing the common agenda: a customs union, a common market (both of which would entail formal negotiation), and a uniquely North American route to strategic integration. A key point about each option is that it contains enough that would be interesting to the United States to allow Canada to achieve its goals.

Deeper Integration: Factors to Consider

Any economy that is now integrated into the world marketplace must react to and anticipate rapid economic change — or be overwhelmed by unexpected external shocks. The 1997–98 Asian crisis is one example of the latter. The fundamental question with which each government must grapple is how to *manage* integration in ways that serve the national interest. A major proposition here is that a nation that merely reacts to events is likely to see its sovereignty erode and its future determined by others. In contrast, a nation can exercise its sovereignty by anticipating change and preparing options that promote the major interests of its partners but channel action in ways that best serve its own interests.

The next logical question is, what realities must Canada consider in choosing a route to deeper integration? Two points seem urgent. How do we regard Canadian sovereignty? And how do we attract US interest in the common goal? A third is a broader strategic issue: should we include Mexico or a wider Latin American group?

Exercising Canadian Sovereignty

The prospect of deeper, policy-led North American integration immediately raises issues of political independence, especially for Canada, situated beside a large, wealthy, and dynamic economy, now the world's only superpower. Sovereignty debates have raged in Canada since the country was formed. In the past decade, as Canada's living standards and economic performance have lagged behind those in the United States, more voices are heard calling for deeper integration. In the early

1980s, worries that increased US protectionist pressures could erode market access motivated proposals to negotiate the bilateral FTA (see, for example, Canada 1982; Canada 1985; Lipsey and Smith 1985). Ambivalence about the sovereignty issues of implementing the just-concluded FTA was the central issue in the 1988 federal election.

What does sovereignty mean in an increasingly interdependent and, since September 2001, an increasingly vulnerable world? The traditional definition of *sovereignty* refers to a country's determination of key policies and national control of decisions affecting its governance. To date, the liberalization of trade and investment have had two different impacts on sovereignty. One is to diminish it in a fairly routine way. In the negotiations of the World Trade Organization (WTO), for example, a country binds its tariffs in exchange for reciprocal bindings by its trading partners. Complaints arise, not because of sovereignty diminution, but because "other" countries are not living up to the commitments they have made. Sovereignty may be diminished, but it is not given up.

The second and arguably more significant impact is to make governments accountable to each other through the rules and procedures of the internationally agreed regimes that they had a hand in constructing — the WTO, for example. Another example is the mechanisms of NAFTA's Chapter 11, which provide a channel for private investors to bring governments to account for violations of that agreement. International regimes tie governments' hands in beneficial ways, such as to prevent backsliding on domestic reforms. In other words, sovereignty is not just about what a country gives up but also about what it gains in more efficient production, larger markets, freer flow of investment, swift resolution of disputes, and greater protection of intellectual property, to name a few of the benefits.

Economic advantage no longer flows only from natural endowments, as the theory of comparative advantage implies. It can be created.

Sovereignty's traditional definition omits an important nuance of twenty-first century economic policy. Economic advantage no longer flows only from natural endowments, as the theory of comparative advantage implies. It can be *created* by investing in physical infrastructure and in human knowledge and skills. The economic structures of the advanced industrialized countries are shifting from natural resources and goods production to knowledge-based activities. These economies are increasingly tied together by trade and capital flows and by production processes and value chains strung across borders, with business segments located where they can act most efficiently.

Thus, a common theme in the international debate about economic integration — that it erodes national sovereignty and causes the nation-state to wither away — needs to be put in a different perspective. States are the architects of their own constraints through the decisions they make, such as supporting international regimes that make them more accountable to other public and private sector participants, and through the decisions they avoid by failing to *exercise* their sovereignty.[1]

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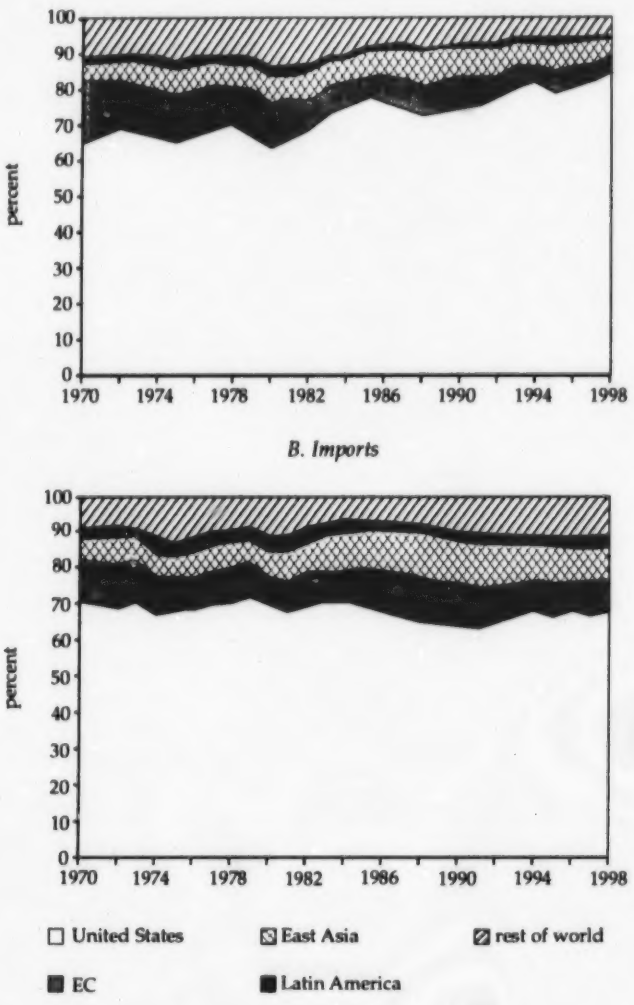
1 Interestingly, Graves's (2001) surveys suggest that Canadians may be ready for this proactive exercise of sovereignty. He detects a change in Canadian attitudes that blends confidence with an appetite for change, a declining affiliation with political ideology (the elites are more ideological than the public), a vibrant multi-ethnic pluralism; and a more discerning role for government as partner rather than parent. This insight leads Graves to propose that Canada could successfully emerge as the vanguard postmodern state; one that solves the balance between identity and globalization.

Figure 1: ***The Direction of Canada's Trade, 1970–98***



Source: Safarian and Hejazi 2001.

Attracting US Interest in Deeper Integration

Canada has a long history of policy- and market-led economic integration with the United States. Substantive trade-liberalizing policy initiatives date back to the 1930s, when each of the two countries initiated tariff-reducing negotiations.[2] In some ways, these policy efforts peaked with the Canada-US FTA proposed in 1985 and implemented on January 1, 1989. (For many Canadians, the NAFTA was a defensive extension.) US interest in the FTA was strategic. The Uruguay Round of multilateral negotiations under the General Agreement on Tariffs and Trade (GATT) was proving difficult to get started, and a regional initiative provided an opportunity to force the Europeans to the negotiating table.[3]

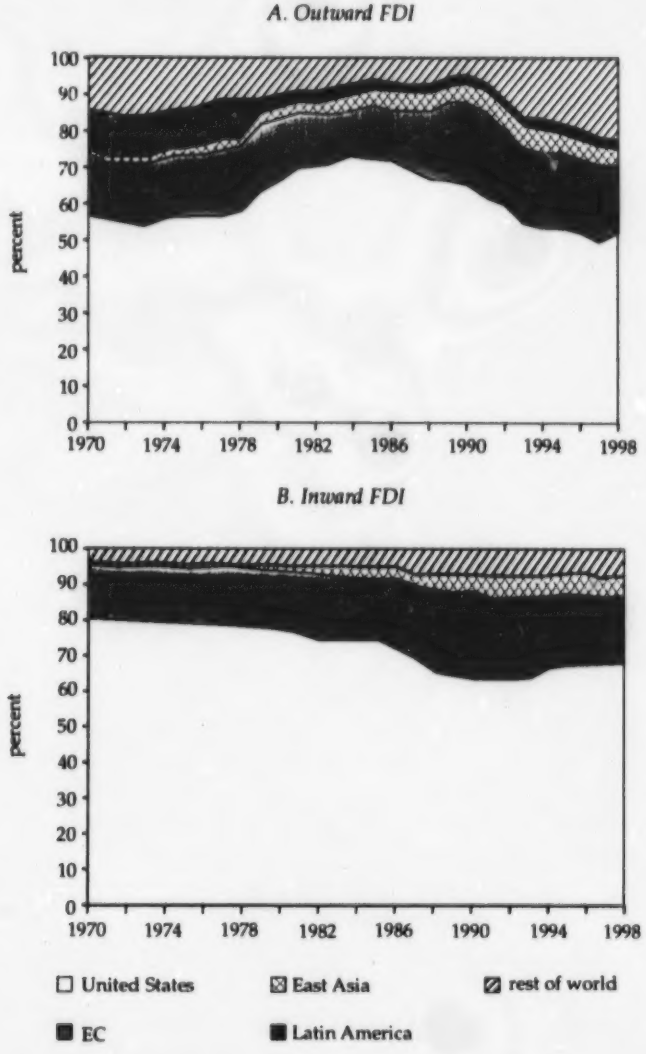
Implementation of the FTA, coinciding as it did with the fall of the Berlin Wall, came during a difficult period of global adjustment when new markets and stiff new competition emerged. The United States became a major beneficiary of what has come to be known as *globalization*. Canada, in contrast, has struggled with major economic adjustments to this new environment.

Today, the two economies are closely intertwined (see Figures 1 and 2). Nearly 90 percent of Canada's exports go to the United States, up from 75 percent in 1990. Seventy percent of Canada's imports come from the United States, a share that has not changed much over time. But integration through FDI has declined, reflecting the rising interests of and opportunities for investors of both countries in other parts of the world. Half of Canada's outward FDI stocks are now located in the United States, but this share has dropped from more than 70 percent in the mid-1980s. Similarly, 70 percent of inward FDI located in Canada comes from the United States, down from 80 percent in the 1970s and 1980s (see Safarian and Hejazi 2001).

2 As distinct from rhetorical initiatives, such as Sir Wilfrid Laurier's ill-fated proposals in 1911.

3 Some eight years later, a US-supported agreement in the Asia-Pacific Economic Cooperation (APEC) set targets for free trade in that region that helped persuade the Europeans to return to the table to finish the round.

Figure 2: ***The Direction of Canada's Foreign Direct Investment, 1970–98***



Source: Safarian and Hejazi 2001.

In 2002, Canada risks a dialogue of the deaf if it pursues an economic goal of deeper bilateral integration without taking account of US security preoccupations. Indeed, Canadian policies, particularly those affecting US security interests, are a current US congressional and bureaucratic concern. Even though most of the September 11 hijackers had US visas, suspicions persist of a porous northern border.

Thus, a strategic goal that might stimulate US interest is *North American* economic security — cooperation between neighbors to produce the public goods of homeland security and economic stability that neither country can produce on its own. The Smart Border Declaration signed in December 2001 is a good start in this direction, but much remains to be done.

Involving Mexico in Deeper Integration

Relationships among the "three amigos" still amount to two bilateral relationships with the United States, rather than a new community, although some observers (Blank 1993) argue that the "architecture" of a community is discernible through the NAFTA commissions. The US economy accounts for 90 percent of total NAFTA production, nearly 70 percent of NAFTA's population and it is the destination for most of its neighbors' exports (see Table 1). The Canada-Mexico economic relationship, by contrast, is small (see Figure 3) and it is growing rather slowly.

The political economy of the two countries' relationships with the United States differs because of their different histories, sensitivities' and priorities. Some argue, therefore, that it makes sense for each country to pursue parallel arrangements with the United States (see, for example, Hart and Dymond 2001). In addition to trade and investment agreements, Canada's historical ties with the United States encompass a wide range of initiatives, from the North American Air Defense (NORAD) pact to common membership in international governance and security institutions, such as NATO, the Organisation for Economic Co-operation and Development (OECD), and Group of Seven (G-7) economic summits.

In contrast, the central issue between Mexico and the United States is illegal migration. Most Mexicans in the United States have arrived in the past two

Table 1: ***Characteristics of the NAFTA's Three Amigos, 1999***

	Gross Domestic Product	Population	Trade Dependence on NAFTA Markets
	(% of NAFTA total)		*(% of total goods exports)*
United States	90	69	36
Canada	6	7	86
Mexico	4	24	86
Total *(millions)*	$9,795,870	409	$1,068,110

Source: Pastor 2001, 7.

decades. Estimates from the US Immigration and Naturalization Service (INS) put the number of illegals at 4.0 to 4.5 million in 2000 (Pastor 2001). The Guanajauto Proposal, a joint communiqué issued by the two countries' leaders February 2001 is instructive:

> [W]e are instructing our governments to engage, at the earliest opportunity, in formal high-level negotiations aimed at achieving short- and long-term agreements that will allow us to constructively address migration and labor issues between our two countries. This effort will be chaired by the Secretary of State and the Attorney General of the US, and the Secretary of Foreign Relations and the Secretary of the Interior of Mexico. (Mexico 2001b.)

The proposal also reflects the seriousness of Mexican President Vincente Fox's intention:

> [A]fter consultation with our Canadian partners, we will strive to consolidate a North American Economic Community whose benefits reach the lesser-developed areas of the region. (Ibid.)

As Pastor (2001) notes, the United States cannot afford to ignore President Fox's vision of a common market. If it were to change its current neutral stance, Canada would have to be involved.

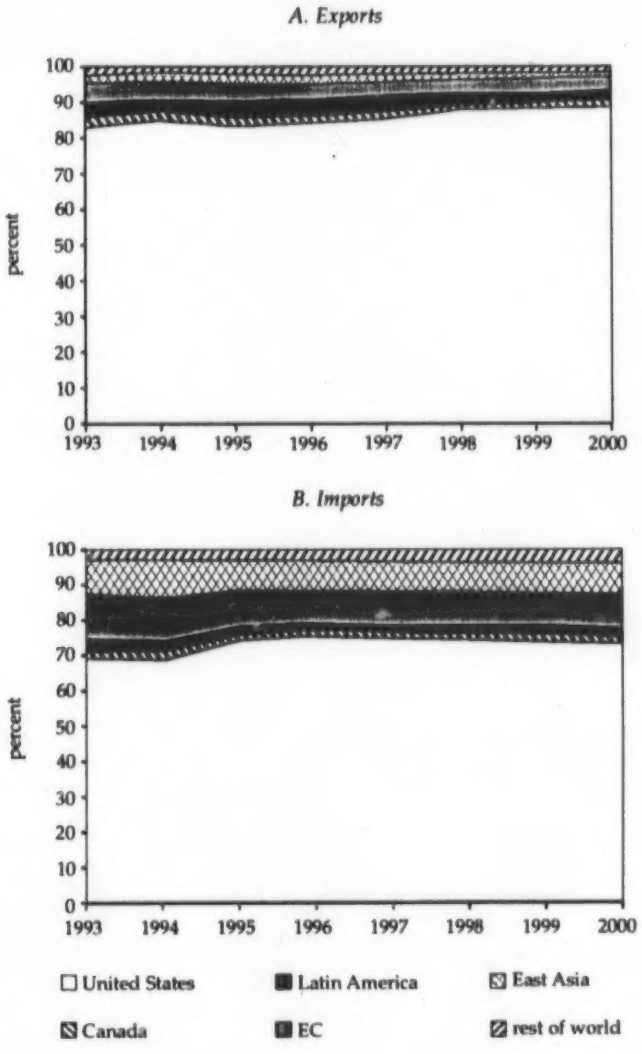
Both Canada and the United States have interests in and responsibilities to help Mexico develop and grow. For these reasons, Canada should be proactive if any Mexican-US discussions develop. The alternative is a hasty rearguard action to ensure Canada is included only as an afterthought.

This discussion suggests a related issue. Should Canada put all its eggs in the one basket of deeper integration primarily with the United States? Or should it use hemispheric negotiations to dilute the inevitable US dominance of a bilateral deal? It is useful to recall that the original FTA negotiations proposed by Canada led to the NAFTA and, along with the Clinton administration's Enterprise for the Americas Initiative, provided the basis for the Free Trade Area of the Americas (FTAA) negotiations that were launched in 1998. Since the NAFTA, Canada has also maintained a trade-liberalizing momentum in the hemisphere, entering into bilateral FTAs with Chile and Costa Rica.[4] US interests in closer regional trading ties are to promote growth after the protracted Latin American debt crisis in the 1980s and to promote democracy in Latin America.

If Canada were to rely on broader negotiations along these lines, something that resembles the European model could eventually emerge because of the larger number of players. But the FTAA is to be a free trade area among economies of diverse sizes at differing levels of economic and political development. It is the

4 And beyond, through FTA negotiations with Singapore begun in 2001.

Figure 3: ***The Direction of Mexico's Trade, 1993–2000***



Source: Mexico 2001a.

first step toward regional integration that will take many years to deepen into anything resembling the degree of integration between the United States and its two immediate neighbors. The FTAA, therefore, should be pursued in parallel with the Canadian-US (and possibly Mexican) initiative.

In sum, if Canada is to exercise its sovereignty rather than react to outside pressures, it should pursue a strategic initiative with a common goal that is likely to interest the United States. That approach would allow Canada to shape the economic agenda at a time when US preoccupations lie elsewhere. This economic security agenda could be advanced largely on a bilateral basis, rather than including Mexico at the start, since the existing North American framework for trade and investment still largely reflects the two bilateral relationships.

Introduction to the Issues

This section introduces the issues that might be included in such a strategic policy agenda. I begin with the economic dimensions of integration that largely concern Canadians. I then explore the security issues that would be key to attracting US attention but would also serve Canadian interests.

Public policies have historically facilitated North American integration. The FTA and NAFTA reduced traditional tariff and nontariff barriers to market access and introduced a dispute settlement mechanism aimed at subjecting bilateral disputes to objective scrutiny. Governments increasingly recognize that by adopting framework policies that make a country a relatively desirable place to work and invest in, they can influence that country's competitive advantage. A country does not have to be large to succeed; economic growth is not related to country size as demonstrated by Ireland, Finland, Singapore, and the Netherlands — all small countries with high productivity and incomes.

Canadian Interests

The challenge is to convince the United States that the goal of North American economic security is in *both* countries' long-term interest. Canadians seek greater assurance of access to US markets — but on our terms, without sacrificing political

independence or distinctive institutions, such as public services, and our own approaches to labor market issues and immigration. Many questions arise. For example, what are the implications of increasing labor and capital mobility within North America? Where does the exchange rate regime fit in? How should policy guide management of the trade and investment disputes that inevitably would arise with deeper economic integration?

Labor Mobility and Deeper Integration

Rising trade and FDI flows increasingly require that people also move more freely. Yet crossborder labor mobility is still restricted in North America.

Rising trade and FDI flows increasingly require that people also move more freely. Yet crossborder labor mobility is still restricted in North America, despite the provisions of the FTA and NAFTA that facilitate movement of business people and professionals. (The purpose of the North American Agreement on Labor Cooperation, a side agreement to the NAFTA, is to ensure that each country enforces its own labor standards.) The European Common Market has progressed much further than North America, removing most barriers to the free flow of people to jobs anywhere in the European Union (EU).

The need for North American labor mobility has several dimensions. First, the growth of crossborder production networks requires people to move, permanently or temporarily, to be near their customers. Second and related, the prominence of US and US-based multinationals also requires that business and professional people move frequently and fairly freely across national borders. Existing restrictions may be a factor that encourages FDI to bypass Canada for the United States. Third, in recent years, increasing numbers of highly skilled workers, many of them newly trained, have headed to the United States, attracted by job opportunities and relatively higher incomes in the booming high-tech sector. Greater freedom of movement could reduce their tendency to stay in that country.

Richard Harris (2001) points out that full labor mobility is not essential, even in a common market. But the greater the labor mobility, the greater the efficiency gains. He suggests that the long-term policy objective should be to arrive at a situation in which mobility does not depend on skill levels or the state of local labor markets. People should be able to make location decisions that are in their own best interests.

Factor Mobility and Tax Policy

Regulatory barriers to crossborder capital flows, in contrast to those on labor, have largely been removed. But differentials in the Canadian and US tax regimes, particularly for business taxes and withholding taxes on income paid to nonresidents, impede these flows.

On its own, Canada can address one of these impediments — certain features of its tax structure. The federal and provincial governments have recently taken steps to make the country more attractive for foreign investment. By 2005, for example, the general federal-provincial corporate income tax rate will be reduced, on average, from about 43 percent to 31 percent, well below the combined US average rate of 39 percent. Yet in 2005, taking into account all the features of the corporate tax system, including capital taxes, the effective tax rate on capital in

Canada will still be similar or slightly above that for US investments (see Mintz 2001b for an analysis).

Another impediment is bilateral differences in withholding taxes on dividends, interest, and other payments of income to nonresidents. Such taxes inhibit the integration of capital taxes in North America. The EU found integrating capital markets sufficiently important to abolish withholding taxes in the 1990s. Mintz (2001a) estimates that eliminating both Canadian and US withholding taxes on such payments would lead to a substantial increase — on the order of $28 billion annually — in the capital invested in Canada. The annual income gain that Canadians could realize is about $7.5 billion annually. The efficiency gains associated with removing such taxes could outweigh the revenue losses to governments.

The rise in multinational business in North America has resulted in a sharp increase in intrafirm trade, which now accounts for more than 50 percent of total bilateral trade. Given the problems inherent in measuring transfer prices for goods and services sold within multinationals and determining the allocation of costs within an organization, national tax authorities face a myriad complex issues in trying to tax the income of such companies. Thus, some form of harmonization of the tax bases for corporate income tax is becoming increasingly important as a response to intrafirm trade.[5]

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Coordinating taxation in other areas, such as personal income taxes, and sales taxes, is less needed. Tax competition among governments can be healthy (although not if governments engage in beggar-thy-neighbor competition) in that people and businesses move to the jurisdiction offering the best combination of public services and taxes.

The Exchange Rate Regime

The volatility and secular decline of the Canadian dollar against the currency of its largest trading partner is a source of continuing angst in this country.[6] Would a move to a closer tie with the US dollar — through a fixed exchange rate, a currency

5 Recently, the EU engaged in a discussion of corporate tax integration and considered adoption of some form of apportionment rule for corporate income similar to that found in Canada and the United States. Canada's provinces have agreed to a common base and formula for income apportionment, but US states, which collect far less corporate income tax, have achieved far less harmonization; states choose their own tax parameters, such as factor ratios, and their own tax bases (which do follow the federal tax base). Thus, companies operating across the border face a bewildering complexity of tax rules that raise transactions costs.

6 Explanations of the falloff vary. The Bank of Canada has a simple and well-documented explanation: commodity prices, which are a major determinant of the bilateral nominal exchange rate, are declining as world trade and industrial production becomes more knowledge- and less materials-intensive. When commodity prices fall, demand for the Canadian dollar also plunges (Murray 1999; Laidler and Aba 2002). Others point to a change in the structure of Canadian exports to manufacturing (mainly autos) and services, in an increasingly globalized world, where the currencies that matter for international transactions are the US dollar and the euro (the yen less so); thus, the floating Canadian dollar has been misaligned (see Harris 2001). Another thesis is that Canada's weak productivity performance can be explained by the "high cost of doing business in Canada" due to a high tax burden and misallocation of government expenditures. The higher relative costs of doing business contribute to a weakened currency, as do expectations of higher border costs. (Mintz 2001b presents some empirical estimates.)

board, or a common currency — alleviate the situation, benefit North American economic security, and be acceptable to citizens on both sides of the border?

Canada has considerable freedom of choice of currency regime. Factors that can influence the availability of choice include the size of the economy (smaller economies have less choice because their currencies are increasingly thinly traded internationally); the soundness of the domestic financial system (Canada's financial system is diversified, sophisticated, well supervised, deep and liquid); the credibility of central bank policy (the Bank of Canada has a large stock of credibility as an inflation fighter — its main task — acquired during the past decade); and the degree of financial integration (Canada's financial system is deeply integrated into world markets). Canada's financial system is part of its "new economy"; it is a large knowledge-based industry that has world-scale ICT capabilities. These strengths all imply that Canadian businesses have the necessary tools to deal with exchange-rate volatility.

Nevertheless, the debate about dollarization is unlikely to fade away unless the Canadian dollar strengthens significantly. Several strategic questions need examination. For example, what would be the real costs of converging on US macroeconomic performance? What would be the technical steps, and would they be feasible? Studies show a low extent of existing dollarization[7] implying a substantial cost to be paid to shift.

Perhaps most important, would such a policy shift be politically sustainable? The exchange rate regime is ultimately a political as well as an economic question. A nation is a society, not just an economy. It is a group of people with shared interests in doing great things together. The currency, like the anthem and the flag, has symbolic value. Are Canadians willing to give that up? The fixed rate options would require varying degrees of sacrifice of political and monetary sovereignty. Europeans (who have hundreds of years of experience with this debate) emphasize that common currency arrangements in the past have survived only when, at the time of their creation, a federal government structure was well established and stronger and more legitimate than is currently the case in the EU. In other words, common currency arrangements until now have been supported by a level of political integration that is far deeper than the near-zero level that currently exists in North America. Indeed, other than the European Monetary Union (EMU), most currency unions in the past 100 years have been created among subnational states, such as among the states in the United States and by subnational units in Italy and Germany, or by colonies and their former masters. Only the monetary union in 1922 between Belgium and Luxembourg existed without political integration (until it was absorbed into EMU at the end of the century).[8]

The currency, like the anthem and the flag, has symbolic value. Are Canadians willing to give that up?

The final question is whether the United States would be interested. Our domestic debate has a note of surreality because it is entirely made-in-Canada. Although some Americans have revealed passing curiosity, the US electorate has

7 Laidler and Poschmann (2000) make such an estimate in a study of the feasibility of variants of possible common currency arrangements. They conclude that dollarization is the only feasible option — and reject its costs as greater than its benefits.

8 Buiter (1999) makes these observations.

shown no interest in either giving up its currency for a regional one or sharing any aspect of domestic monetary policy sovereignty.

The Management of Trade Disputes

Trade remedy law refers mainly to the use of antidumping and countervailing duties. Although these complaints are of concern in multilateral trade negotiations, the United States designed its own laws to protect its producers against imports deemed to be subsidized or unfairly priced. Over time, these US laws have achieved notoriety for two reasons: the investigations under them are perceived to be politicized, and US producers have tended to use these laws to limit import competition.

Since 1980, when the United States introduced its current trade remedy laws, it has undertaken more than a thousand investigations (see Macrory, forthcoming). Canada, as the largest US trading partner, has been the subject of many of them.

One of Canada's major achievements in the FTA was to discipline the use of these laws through an objective, bilateral dispute resolution mechanism (DRM), which was refined in NAFTA Chapter 19. When the DRM was first introduced in 1989, it was seen as an interim measure, resulting from a US compromise in the negotiations. Canada had initially sought substantive change in the US legislation permitting trade remedies. Indeed, the issue became a deal breaker at the eleventh hour, with Canada threatening to break off negotiations if the US side persisted in its refusal even to address the issue. The DRM was agreed on, and both sides committed themselves to finding a permanent solution within a seven-year period. They struck a bilateral working group for that purpose, but its efforts came to nothing.

The current softwood lumber dispute is a much-publicized illustration of some of the persistent problems with US trade remedy law.

The current softwood lumber dispute is a much-publicized illustration of some of the persistent problems with US trade remedy law.[9] Canada's dependence on the US market is great and has risen dramatically during the past decade, as shown in Table 2. By 2000, the United States was receiving 64 percent of Canada's exports of forest products and 97 percent of its forest services exports — ratios not out of line with other industries in the table.

The issue persists because the two countries have different regulatory and legal systems and use different mixes of subsidies and regulation to achieve their objectives. For example, most logging in the United States is on private land. In contrast, most logging in Canada is on publicly owned land (where most Canadian forests are located); companies that log there are charged "stumpage fees." Americans complain that these fees are too low and constitute a subsidy. Canadian governments and producers do not agree. Provincial governments usually argue that such fees do a reasonably good job of reflecting long-term market forces.[10]

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9 Canada's softwood lumber exports have been subject to bilateral complaints since Confederation. The current dispute is the fourth round in the latest battle of this epic "war." (The other three rounds stretch back two decades to a countervailing duty petition brought by US producers in 1982. At that time, the complaint was handled in a quasi-judicial process through the US Commerce Department, which found in Canada's favor.) See Herman (2001) for a historical account of current options.

10 In recent disputes, however, the BC government has pressed for quick settlements to get people back to work. In doing so, it has forgone the opportunities afforded by the DRMs, which take time to resolve.

Table 2: ***Canadian Exports to the United States by Industry, 1990 and 2000***

	Total Canadian Exports		Total Exports to United States		Share of Total to US Market	
	1990	2000	1990	2000	1990	2000
	(millions of Canadian dollars)				*(percent)*	
Agricultural	6,614.62	10,595.45	1,629.37	4,170.87	24.63	39.36
Forestry products	146.33	505.50	35.93	322.78	24.55	63.85
Forestry services	1.99	10.69	1.72	10.37	86.66	97.00
Crude petroleum and natural gas	9,468.11	40,042.83	8,918.03	39,907.45	94.19	99.66
Primary metals	12,049.12	18,098.39	6,890.39	14,700.60	57.19	81.23
Transportation equipment	39,495.98	107,350.59	37,111.49	101,353.70	93.96	94.41
Refined petroleum and coal products	3,561.20	8,547.41	3,355.48	8,459.93	94.22	98.98

Source: Information retrieved from Canada, Department of Industry, Strategis database, as provided by Statistics Canada.

Canadian producers say that their US counterparts, such as the members of the US Coalition for Fair Lumber Imports, which filed the countervailing duty and antidumping petitions on April 2, 2001, are less efficient and resort to protectionist practices.[11]

This time around, Canada has challenged the US measures before the WTO on the grounds that several US government actions in making its determinations are inconsistent with its WTO obligations. US President George W. Bush appointed an envoy who promised a new arrangement by the end of 2001 (a promise he was unable to keep). In addition, Canfor, an exasperated Canadian forest products company, launched a US$250 million compensation claim against the US government under Chapter 11 of the NAFTA.

The new approaches — Canada's appeal to WTO and Canfor's challenge — give Canada some new levers that could influence the future exercise of US trade remedy law. Nevertheless, US complainants assume the ultimate solution is harmonization of the Canadian system to that in the United States. Indeed, a market-access paper tabled by the US government in December 2001 offers to end the dispute, contingent on a judgment by a proposed binational panel that the provinces have carried out the reforms (see Jack and Morton 2001).

The softwood lumber dispute illustrates that the challenges Canada faced in 1987 remain. How can we prevent US trade remedy law from infringing Canadian sovereignty and from spreading to other natural resource industries?[12]

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11 Others note that the US General Accounting Office has found the accounting system of the US Forest Service to be "totally unreliable" (see Stephens 2001).

12 Complicating the issue is evidence from a recent expert review of the BC forest industry that finds many BC forest management practices are outdated, contributing to excess capacity, obsolete mills, and costs that are 40 percent above the world average. For an account of the report prepared by Vancouver consultant Peter Pearse, see "Stumpage blamed for BC wars," *Globe and Mail* (Toronto), December 20, 2001.

And how can we better ensure that the DRM works to handle impartially the inevitable disputes that would arise with deeper integration of the North American economy?

US Interests

Finding a route to deeper North American integration requires examining US interests in reducing the vulnerability of openness.

Finding a route to deeper North American integration requires examining US interests in reducing the vulnerability of openness. The challenge for Canadians is to identify responses that serve Canada's interests as well. The issues include energy, border security, immigration policy, and defense policy. Some readers may be surprised that energy tops the list, but it is now near the top of the US political agenda (whatever one might think about current US energy policy priorities), and over the next few years it could move to the very top. Canada has the supplies. How we play this card could determine how the larger strategic agenda plays out.

Canada's Energy Resources

Canada's energy resources offer a significant but insufficiently recognized opportunity for initiatives that could shape the future management of the bilateral relationship. Because of this issue's potential importance, I deal with it at some length.

Canada, Mexico, and the United States are all significant energy producers that also import from each other. Mexico's energy sector has remained largely immune to free trade in the NAFTA,[13] but US-Canadian energy trade is largely driven by market forces. The respective energy sectors are still encumbered by domestic regulatory barriers, but much of Canada's energy infrastructure is already linked with US markets. Thirty-five natural gas pipelines, 22 oil pipelines, and 51 electrical transmission lines link the two countries.[14]

The United States depends on imported crude for 60 percent of its requirements. Canada supplied 15 percent of these in 2001, just ahead of Saudi Arabia (14.7 percent), followed by Mexico (13.7 percent) and Venezuela (11.3 percent) (Walker 2001). By statute, the United States is prohibited from exporting crude petroleum, although the FTA made Canada an exception (which was not extended to Mexico under the NAFTA). The United States is also a major net exporter of natural gas to Mexico, and it is a net importer of electricity from both Canada and Mexico.

The FTA energy provisions cover trade in petroleum, natural gas, electricity, and the associated fuels for power generation, including coal, uranium, and other nuclear fuels. The agreement contains broad-based commitments to limit government interference in energy trade except in extraordinary circumstances. It prohibits minimum export price requirements as well as export taxes (unless the taxes are also levied on sales for the domestic market). These prohibitions limit the tools traditionally used to implement government-enforced price discrimination in favor of domestic energy users. Narrowly defined exceptions to the prohibitions on trade

13 NAFTA negotiations failed to break the monopoly held by Pemex, Mexico's national oil company, on exploration and development and on gas and fuel sales (Hufbauer and Schott 1993).

14 "Attacks prove need for closer ties," *Calgary Sun*, November 6, 2001, p. 40.

restrictions are confined to situations involving national security. Either country may also restrict exports for three specific "economic" reasons: to relieve supply shortages, to maintain a domestic price-stabilization program, or to prevent exhaustion of a nonrenewable resource (Hufbauer and Schott 1993, 205).

The United States' major energy policy goal is energy security. It is a major consumer of fossil fuels but produces less than its total requirements. Since the early 1980s, US presidents have called for continental energy plans — coordination with Mexico and Canada to ensure access to their exportable resources. These issues have always been difficult to deal with because both Canada and the United States have complicated and decentralized regulatory policies, with decisionmaking shared between the provinces or states and the federal governments (see Pastor 2001, 133–135). Security of supply has become more urgent in the past year because of concerns about disruption of offshore supplies. Some experts predict an 80 percent possibility of such disruptions in the next two years.

Canada has a major energy supply opportunity. The challenge is to organize effectively to press this advantage.

Canada has a major supply opportunity. The challenge is to organize effectively to press this advantage. A step in this direction was taken in 2001, when a Canadian task force, struck under the leadership of John Manley, then foreign affairs minister, met briefly to coordinate a Canadian response to the *Report of the National Energy Policy Development Group* (United States 2001). One recommendation of that US presidential task force is for a three-way discussion through the North American Energy Working Group "to develop closer energy integration among Canada, Mexico and the United States and identify areas of cooperation, fully consistent with the countries' respective sovereignties." Its second recommendation is "to work closely with Canada, the State of Alaska, and all other interested parties to expedite the construction of a pipeline to deliver natural gas to the lower 48 states."

Significantly, pursuit of this market opportunity would not require regulatory changes, with the significant exception of responses to the Kyoto Protocol on greenhouse gases.[15] Since the provinces own the resources and bilateral energy trade is subject to market forces, the Canadian response to these integration recommendations could be based on a careful but comprehensive strategic approach that took account of the diverse supply capabilities in different parts of the country — natural gas from the Mackenzie River delta in the Northwest Territories, oil sands in Alberta, oil and gas in the Atlantic provinces, and electric power supplies from several provinces.

Several matters would have to be sorted out. One is to understand what US producers' intentions of transporting Alaskan natural gas to US markets might mean for Canadian resources in the Arctic. The Alaska route would not necessarily mean that a Canadian project to bring gas from the Mackenzie River delta gas would be superseded by the Alaskan proposal. Indeed, both proposals may be feasible. The second point is federal-provincial relations: close cooperation, rather than competition, among the federal government and the provinces would be consistent with a strategic approach. The third is to address aboriginal interests in

15 Although the US government pulled out of the process leading to the Kyoto Accord in spring 2001, the Canadian government has continued to pursue its commitments even though industry commentary indicates the target dates for compliance are unrealistic. The actions required for Canadian industry to meet these targets could seriously undermine competitiveness if US counterparts are not subject to the same regime.

Box 2: ***The Economic Importance of the Canada-US Border: Some Numbers***

A few statistics begin to suggest the part the bilateral border plays in the Canadian and US economies.

- 70 percent of Canada-US trade is transported by truck.
- Trucks made 11 million crossings in 2000.
- 100,000 passenger vehicles cross the border every day.
- The Ambassador Bridge between Windsor and Detroit handles 7,000 trucks a day, 24 hours a day.
- 75 percent of bilateral trade in goods moves through one border crossing in British Columbia and four in Ontario.
- 85 border crossings are noncommercial.
- Eight of the top ten border crossing are either bridges or tunnels.
- 200 million individual crossings take place each year, averaging half a million a day.
- 15 million Canadians visit the United States for a day or more each year.

Sources: Hart and Dymond 2001; and public sources.

the Canadian north. The fourth is to find ways to maximize electric power exports from the various provinces.

A final point is that part of Canada's strategic approach to bilateral or continental energy arrangements must take account of the country's tax and regulatory regimes, particularly its position on the Kyoto Protocol. If the latter hinders Canada's advantage, what measures can be taken to alter either the US or Canadian position to remove this constraint?

US demand is there for an appropriate Canadian response.[16] A successful initiative will require careful preparations in Canada.

The Border: More Secure but Open

The future economic prosperity of Canada — and the United States — depends on seamless transactions across the world's longest undefended border. Box 2 suggests the economic importance of the two-way trade in goods and services, transportation, and the movement of people. Crossborder flows are huge and concentrated at a small number of crossings. The way Canada deals with the border, given that other countries face similar security challenges, could have a significant impact on how it is viewed in future as an investment destination.

Despite the NAFTA, the major security shock of September 11 has undermined confidence in Canada's unfettered access to the US market. Suddenly, years of efforts by officials in both countries to reduce border congestion and related transactions costs (through high-tech identity cards for frequent travelers and pre-inspection of goods shipments) seemed about to be reversed. Nowhere was this truer than in the auto industry, for which the border has largely been erased, beginning with arrangements made in the 1965 auto pact. Common ownership in

16 Although environmentalists argue that the US president's supply-side focus is misguided; a superior resource allocation strategy, they argue, is to push conservation technologies.

the industry has also been an important factor in the rationalization of production on both sides of the border. Most trade is now intrafirm. Many of the border-facilitation measures for goods advocated in the wake of September 11 follow models already in practice for automotive products (see, for example, Tellier 2001).

Copycat terrorist attacks seem likely in the future. The US Congress has ordered significantly beefed up border staffing. The INS plans to introduce an entry/exit system by 2003 at airports and seaports and by 2004 at the 50 largest land-entry points. This proposal would require visitors, including those from Canada, to have their names recorded every time they enter or leave the country.

The potential longer-term impact of a permanent increase in border security would be to raise transaction costs, acting like an added tariff on two-way trade.

The potential longer-term impact of a permanent increase in border security would be to raise transaction costs, acting like an added tariff on two-way trade. The higher costs of Canadian imports would cause US customers to switch to cheaper domestic and alternative foreign suppliers. Canada's nominal exchange rate would then depreciate as the demand for Canadian dollars declined, making key imports more expensive and undermining Canadians' living standards. Higher costs of moving people, goods, and services would also undermine Canada's productivity performance. If international investors headed for North America bypass Canada, going into the United States to serve Canada from there, Canada's productivity growth would be negatively affected.

Canada's response should be to head off these higher costs with a proactive security agenda. After a period of uncertainty and delay, Ottawa did introduce a legislative framework in Bill C-36 (anti-terrorism legislation amending ten statutes and ratifying two United Nations Conventions on the suppression of terrorism). To develop this framework, Canadian officials advanced proposals behind the scenes to US officials. By early December, the Joint Statement of Cooperation on Border Security and Regional Migration was jointly announced by John Ashcroft, US attorney general, Elinor Caplan, then minister of Citizenship and Immigration, and Lawrence MacAulay, solicitor general. The December 10, 2001, federal budget followed with implementation projects to cost $6.5 billion. Several days later, Foreign Minister Manley and US Homeland Security Chief Tom Ridge signed the Smart Border Declaration.

These measures, which, in principle, have the widespread support of Canadians, have four objectives: to ensure air travel safety, to step up intelligence and policing, to increase emergency preparedness, and to increase the screening of immigrants and refugees. The Smart Border Declaration includes sensible measures to secure the border for goods and to keep it open. It addresses infrastructure issues that have been neglected for years. But at present it is simply a declaration. The challenge is to follow through with action now that the necessary political will exists to act — and to sustain that will on both sides of the border.

In carrying through, Canadians should realize that most of our competitors also face higher border security costs. Thus, being in the forefront of innovation in automating *seamless* border security could become a source of Canadian competitive advantage.

Immigration Policy and Anti-Terrorism

Crossborder movement of people needs careful handling in this new anti-terrorist world. Some measures would speed the movement of business travelers, and

others slow the processing of immigrants and refugees. Each year, Canada receives approximately 10 million visitors (excluding those from the United States), most of them through the large international airports at Montreal, Toronto, and Vancouver.

Canada and the United States have pledged themselves to joint reviews, cooperation, and synchronization of procedures. Increased numbers of immigration officers are to be stationed abroad to improve the information on which they rely when granting entry. A "safe third-country" agreement is in train to enhance the management of refugee claims. Under contemplation are permanent resident cards, including a biometric identifier, as well as a Canadian presence on the US Foreign Terrorist Tracking Task Force. Also possible is a stronger presence for the US Federal Bureau of Investigation (FBI) in Canada.

These measures should increase confidence that people coming to North America from third countries do not have malign intentions. But the new efforts at coordination, joint action, and intelligence sharing move perilously close to policy harmonization that could compromise Canadian values.

Further analysis of both the goals and implementation of immigration and refugee policies in Canada and United States is required. Preliminary work on this subject suggests there are large areas of agreement between the two countries, particularly on immigration policy (Rekai, forthcoming). The numbers differ with respect to both annual immigration targets and illegal migrants. The two countries have quite different profiles for selecting permanent residents, with Canada more focused on a demographically inspired, well-educated, highly skilled immigrant, and the United States on family reunification. Both countries accept an internationally agreed definition of a refugee, and both obtain a small portion of their refugee intake from camps abroad. Both have similar appeal processes for "inland" claimants. These processes are slow and cumbersome, however, and enforcement systems are so weak that authorities lose track of many applicants. The US government and media have criticized Canada's practice of releasing potential security risks while they are in the refugee or general enforcement process. Ironically, the area that may be most in need of rethinking is visitor visa policy. The potential attractiveness of affluent and educated applicants was undermined dramatically by the personal characteristics of the September 11 hijackers.

Will Canada be able to maintain its desired objectives for immigration and refugee policies? The question matters to the extent that our goals reflect basic Canadian values as distinct from US ones.

Will Canada be able to maintain its desired objectives for immigration and refugee policies? The question matters to the extent that our goals reflect basic Canadian values as distinct from US ones. One of the explanations for the uncertain and slow responses by both Canada and Mexico to US homeland security concerns after September 11 was anxiety about sovereignty. After a time, it became apparent to both governments that they had little choice but to go along. The Mexican government did a *volte-face* with a public offer to coordinate customs and intelligence gathering,[17] while the Canadian response was much less public and more anticipatory.

The key point going forward is to ensure that Ottawa is proactive and strategic in advancing Canadian interests while meeting US objectives. Coordinating action, adopting best practices, and sharing intelligence are sensible first steps. Even more could be achieved through the European practice of mutual recognition of standards

17 See "Mexico moots border plan to protect economic lifeline," *Financial Times*, October 11, 2001.

without policy harmonization. Immigration and refugee policies reflect foreign policy objectives to some extent, but less than some critics would like to think. What is at issue over the longer term is labor market policy. The European experience shows us that a country should not embark on piecemeal policy harmonization in this area and must act within a clear and acceptable political framework.

Defense Policy

September 11 has also pushed the traditional governmental roles of defense and security far up the agenda in North America. Globalization restricts what governments are able to do, and so their role has been pruned back in a number of countries, often with positive results for private sector dynamism. But governments are responsible for providing such public goods as defense and military security.

Military expenditures seem certain to be one price Canadians must pay for economic openness. A number of questions will require public choices. For example, some people argue that Canada's NORAD assets must be renewed. Others call for re-examination of Canada's maritime capacity to monitor its extensive ocean boundaries. Highly mobile land force units are also required for functions that range from response to natural disasters to peacekeeping to combat roles such as the Canadian Forces have undertaken in Afghanistan. Air and sea units to provide the necessary mobility may also be required. What will it cost to pursue these objectives? Are Canadians willing to pay the price for all such roles? For some but not others? Or would Canadians prefer to continue to free ride on US military capability?

Canada's Options

The tragic events of September 11 and its aftermath have opened a door of opportunity for Canadian policy to advance a long-term agenda for North American security.

As summarized above, the tragic events of September 11 and its aftermath have opened a door of opportunity for Canadian policy to advance a long-term agenda for North American security. This agenda could address both US security preoccupations and Canadian concerns about more assured market access. A more secure bilateral border could, however, create uncertainties about higher costs — acting like a new tariff on goods exports and imposing higher transactions costs on services exporters.

Both countries should address these issues. The United States needs to be convinced that North American security should include economic security. To attract and retain the US interest in this goal, Canada should pursue a strategic agenda. What might this agenda be and how might it be pursued? Approaches to these questions are the subjects of this section.

In considering our options, we need to remember that, as already observed, a nation that merely reacts to events is likely to see its sovereignty erode and its future determined by others. A nation that exercises its sovereignty anticipates change, prepares options that promote the key interests of its partner, but channels actions in ways that best serve its own interests. Unfortunately, one can argue that Canada's recent disappointing economic performance, including the low dollar and our declining share of foreign investment headed for North America, as well as growth, employment, and productivity lower than in the United States (though also lower inflation) condemn us to dealing from a weak position in any bargaining with the United States.

This position has a grain of truth. In a world in which comparative advantage can be created and production takes place in value chains strung across borders, governments face increasing pressure to rethink their role in sharpening the private sector's competitive advantage. Otherwise, their citizens will be attracted to trade, work, and invest in countries that provide opportunities to earn higher incomes.[18] Smart economic policies — proactive and strategically designed policies that promote the sources of economic growth (see Lipsey and Carlaw, forthcoming) — are part of what sovereignty is all about in an interdependent world. Canada should be expressing its sovereignty by providing vision and leadership in the North American economic space.

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Canadians are probably ready for such leadership. Recent studies of attitudes (see Greenspon 2001; Graves 2001) indicate that Canadians are more confident of their identity than they were a decade ago. They are clearer about factors such as the willingness to be tolerant that make Canada distinct from the United States. They are more aware of the strengths and weaknesses of Canadian society. While they prefer the Canadian health care system and Canadian gun laws, they would also like to have the strength of the United States' dollar, its innovative zeal, and its prosperity. As the Canadian economy becomes ever more inextricably tied to that of our southern neighbor, it appears that measures of attachment to Canada are increasing. We are Canadians by will power. Ours is a nationalism of inclusion that allows us to join supranational entities while pursuing our own interests.

How can Canada best pursue deeper integration with the United States? Significantly, September 11 and its aftermath have opened a window of opportunity — but it is closing quickly. We should decide how to take advantage of it.

Close observers of the US political system argue that Canada can achieve nothing of significance by pursuing deeper integration in a piecemeal manner. Indeed, as in recent rounds of the softwood lumber dispute, we could inadvertently give away things that are in our long-term interest. Such an undesirable outcome is possible not because of anything we would do but because of the nature of US governance. Political power is widely dispersed across the executive and legislative branches, within the federal bureaucracy, and among states as well as powerful interest groups. Adjustments in US programs or legislation are, therefore, almost impossible to achieve. Indeed, in some ways the tide is moving against us. Each bureaucracy, for example, is now responding to the homeland security imperative with its own administrative actions. One example is the INS Visitor Sign-in and Sign-out proposal. In the larger domestic political scheme of things, this program would be a small one that made good sense and won political points for its proponents. For business travelers who must cross the border frequently, however, it is a serious increase in transactions costs.

What we require are large initiatives that address US objectives at the same time that they open new economic opportunities. Neither Canada nor Mexico is directly threatened by terrorism. Neither is running a war. Either or both countries can pursue three possibilities, discussed below. Each is a Big Idea (but not necessarily a new one).

A major strategic bargain would afford the opportunity to advance a vision of North American economic security and to obtain linkages that would be out of reach

18 Mintz (2001b) provides evidence of how Canadians are disadvantaged by both circumstances and policy decisions.

if we were to proceed on an incremental basis. The NAFTA reduced a number of barriers to trade and investment. Market pressures are forcing further convergence in certain sectors. But obstacles to the free flow of trade and FDI remain. A Big Idea would open new bargaining possibilities in which Canada can leverage its advantages in exchange for what it wants and is otherwise unlikely to obtain. Another factor to consider is that, once the vision and strategic framework were agreed, the objective could be pursued at a more measured pace.

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Big Ideas

The Big Ideas are next steps toward deeper integration. Table 3 differentiates among the usual forms. The ones I discuss here are a customs union and a common market. These two require formal negotiations and harmonization by each party that implies the loss of political autonomy.

- A *customs union* establishes a common external tariff toward the rest of the world, allowing for the free circulation of goods and services within the common area. Such a proposal looks seductively simple, and the WTO rules on what qualifies as a customs union are quite relaxed, requiring only creation of a common tariff. (The European Economic Community was a customs union between 1957 and 1992.)
- Like a customs union, a *common market* is also a formally negotiated step toward a single market within the common area. Not only is internal trade in goods and services freed up; even greater efficiency gains are achieved by allowing people, capital, and technology to circulate freely as well. The benefits of liberalization are measured by the extent to which a single price for a good, service, or factor of production exists throughout the market. These benefits can be realized by harmonizing existing domestic standards, regulations, and policies to a common norm that applies throughout the economic space. The European experience has shown that countries can also achieve these benefits by mutual recognition of each other's standards and allowing competitive forces to bring about adjustment to the most efficient one.
- The third Big Idea is a *strategic bargain*. It does not require large-scale harmonization. It is a pragmatic mix of customs-union-like and common-market-like proposals plus Canadian initiatives in areas of strength that are of particular interest to Americans. The key to the idea is to achieve deeper integration without undermining political autonomy. In addition, this idea recognizes the North American *realpolitik* of asymmetry in economic size and political clout between Canada and the United States and a very small number of potential negotiating partners.

Canada and the United States do not face many of the obstacles that Europeans initially had to overcome. They are already highly integrated. The North American auto industry is the region's largest industry, and it is well down the road to a fully integrated production network that crosses both borders. The steel industry is increasingly regarded as North American. A sectoral customs union already exists in computers and related products. The North American energy sector is subject to

market forces, and its infrastructure is highly integrated. Capital markets are so deeply integrated that regulators are hard pressed to keep up with the pace of technological innovation. Politically, war is only a distant memory. But while Canada and the United States have a goal similar to that of Europe — to achieve economic security — they are clearly constrained by deep attachments to political independence and distinctive national institutions.

Recent global security imperatives, the pressures of globalization on the private sector, and diverging economic performances in Canada and the United States provide the compelling rationale for a unique North American initiative to achieve even deeper integration.

Idea 1: A Customs Union

Until 2001, Canadians paid almost no attention to the idea of a customs union, the next formal step in policy-led integration.

Until 2001, Canadians paid almost no attention to the idea of a customs union, the next formal step in policy-led integration. An FTA allows members to remove trade barriers among themselves but to retain their respective national trade barriers against the rest of the world (see Table 3). Customs inspectors still police the borders to tax or prevent trade. Rules of origin are negotiated in each agreement to ensure that members are not disadvantaged by trade from the rest of the world.

In contrast, the members of a customs union adopt common trade barriers against the rest of the world and eliminate these barriers among themselves. Goods and services flow freely within the union. Customs inspection at these borders is simplified or eliminated. So are troublesome rules of origin.

This interpretation of the customs union is quite simple, and the benefits in North America would be straightforward. Most of the transaction costs associated with rules of origin would be eliminated; border procedures would be expedited; and the possibilities of trade diversion would be reduced, except in cases where one country imposed countervailing duties (CVD) or antidumping (AD) penalties and the other did not. Compensatory measures would then be required, making this alternative somewhat troublesome — but not impossible — to administer (Harris [2001] makes this point). But there are costs. Most important, simple elimination of tariffs would mean that Canadians would still face capricious US trade-remedy laws authorizing the use of CVD and AD penalties.[19]

Canada's interests might be better served by a customs union with a common external trade policy. This idea would involve harmonizing the trade remedy laws of each country, including CVD and AD. Each would lose the ability to impose its own CVD and AD. A common trade remedy regime would also require common procedures available to all firms based in either of the two countries.

Americans have been unwilling to address Canada's concerns about trade remedy law in the past. Would they be willing now? They might be receptive within an overall goal of North American economic security. The US economic structure is shifting to services, and intrafirm and intraindustry crossborder trade is gaining importance. Political priorities may change as the industrial structure alters. But even

19 The Europeans got rid of CVD and AD among themselves when they negotiated their customs union. This was not required for compliance with the rules of the then-GATT. Its purpose was to reduce future commercial disputes.

Table 3: ***Degrees of Economic Integration***

Form of Integration	Free Trade in Goods and Services	Common External Tariff or Commercial Policy	Free Movement of People and Capital	Harmonized or Mutual Recognition of Rules, Standards, Taxation, and Monetary Policies	Supranational Institutions
Free trade area	X				
Customs union	X	X			
Common market	X	X	X		
Economic union	X	X	X	X	
Full economic integration	X	X	X	X	X

if the Americans were interested in a customs union with a common trade policy, the approach would bring costs and risks for Canada. First, it would then become subject to the pressures of US foreign policy toward trading partners — for example, *vis-à-vis* our commercial relationship with Cuba. Second, the common trade policy would require a common negotiating position at the WTO, which could compromise both countries' political independence. Canada would also have to adjust its trade policies with the other countries with which it has FTAs. If Mexico were included in customs union discussions, negotiations would be even more complex since it has a plethora of FTAs.

If Canada were unable to ensure market access without losing political autonomy in important areas, it could pursue an in-between possibility: an evolutionary customs union. Common external tariffs could be negotiated sector by sector, following the precedent in computers and related products. Sectors could enter the union as sectoral tariffs converged between the two countries. Gradually, more and more crossborder trade would be freed from border procedures. To achieve this evolution without the political costs of a full-blown customs union, the two countries could set up a commission to regularly review sectoral tariffs for the purpose of identifying and proposing candidates for the customs union.[20]

Idea 2: A Common Market

A common market is the next step along the road to deeper integration, involving changes that bring domestic markets closer to the single market that exists within a single country. The intent of a common market is to allow goods and services to flow freely across borders and to entitle people to move without hindrance to take advantage of economic opportunities throughout the space. Helliwell (1998) documents economic and noneconomic ties among Canada's provinces that are relatively stronger than those between the provinces and neighboring US states.

A key reality of creating a single market among countries is that common institutions are required to promote it. Such institutions include one to administer

20 This idea was developed in a discussion with Richard Lipsey.

Box 3: *The Road to the European Union*

European governments began the road to a common market early in the postwar period when a few leaders developed a vision of a united Europe in which former enemies would develop common interests and benefits from the potentially huge combined market. Today, the beginnings seem modest: a sectoral arrangement in which France, West Germany, Italy, Belgium, and Luxemburg created a common market for coal and steel with common rules administered by common institutions. This initiative — very bold at the time — created a new common understanding of what was possible, and by 1957 the common market was extended to all goods. In 1970, a combination of US political and economic policies and events in the Middle East produced turbulence in the money and oil markets. In reaction, the European Monetary System was formed in 1978.

The great project languished for some years thereafter, but in 1985, Jacques Delors, president of the European Commission, took up the single-market cause with a passion. Coincidentally, governments had rediscovered an enthusiasm for deregulation. Reliance on *mutual recognition* rather than harmonization, reflected a decision to rely more on market forces than on intervention to remove barriers. Assisting was a policymakers' conviction that microeconomic similarities existed and intergovernmental bargains were possible among the three main players: by that time, the United Kingdom, West Germany, and France.[a] Yet even the architects underestimated the speed with which the single market developed. (The collapse of the Soviet empire in 1989 was a significant contributor to this accelerated pace.)

Subsequently, Delors pushed further towards monetary union with the negotiation of the Maastricht Treaty.[b] It laid the basis for the convergence in macroeconomic performance (particularly low inflation) required for a common monetary policy. It also permitted national central banks to participate and each nation to retain the resources necessary to finance its own policies on security at home and abroad, and on justice, education, health, social security, and regional planning, among others.

Compensating the losers in economic change and helping less-developed members to catch up with the more advanced made adjustment assistance essential, and steady growth in trade and investment provided a lubricant. Strong public support in some less-developed members also helped. The prospect of low inflation and rules and decisions removed from domestic politics stimulated the public support necessary for many painful reforms required to meet the convergence criteria agreed at Maastricht.

[a] Only after the shift in French economic policy with the 1983 "U-turn" did such a similarity appear. See Keohane and Hoffman (1990).

[b] Although a contentious issue in Germany, where opposition to abandoning its highly disciplined monetary policy was intense, tensions were defused by incorporating comparable discipline into the treaty.

a common regulatory framework, another to oversee a common labor market and social policies, yet another to regulate capital markets, and so forth. Since many of these arrangements imply the centralization of bureaucracies and political power, the EU uses the principle of subsidiarity to devolve policy responsibilities to the level of government at which they can be most efficiently carried out. This decentralizing principle, in turn, requires extensive cooperation and coordination within national bureaucracies and among governmental members of the economic space.

Europeans established the legal basis for their common market only in 1992, after member governments had signed the *Single European Act* of 1987, providing

for the removal of all internal barriers. The overriding political goal was to end wars on the continent through political integration. Mexican President Vincente Fox's proposal for a North American common market differs significantly from the European model in that it lacks a comparable political objective and framework.

A brief digression is useful here to consider how the European model evolved. Creating a common market is much more difficult than it looks on paper. The European project took 50 years to realize (see Box 3). Political vision was essential to encourage partners to stick with the project over such a long period of time and through many setbacks. Strong leadership and bargaining among governments as equals played important roles. Progress was step by step, with microeconomic convergence preceding the macroeconomic convergence necessary to introduce the common currency. This progress would not have been possible without common institutions to make it happen (the European Commission and the European Parliament in Brussels and Strasbourg). Such institutions are indispensable to obtain the tough compromises that deeper integration entails and to ensure political accountability to electorates.

A Canadian or Mexican initiative for a customs union or common market would have significant implications for US sovereignty.

The immediate question for North America is whether the United States would be interested in such an idea. A Canadian or Mexican initiative for a customs union or common market would have significant implications for US sovereignty, and for this reason alone, the US administration and Congress could not afford to ignore such proposals. At its core, each proposal would imply harmonization of trade remedy laws, and there are no signs of political willingness even to consider such an idea. From the US perspective, the smaller partners would have less to lose yet they would share in the benefits that flow from the common institutions (as has already been the case with the dispute resolution mechanisms in the FTA and NAFTA). In addition, neither alternative addresses the US homeland security objective.

For their parts, the smaller partners would have to weigh the potential benefits of deeper integration against the risks of losing sovereignty and being forced in the asymmetric negotiations toward harmonization with the laws, standards, and policies of the United States.

Idea 3: A Strategic Bargain — A Pragmatic North American Route

Sovereignty is not just a Canadian concern. It is a deeply ingrained, indeed constitutional, factor in US choices. The route to strategic integration is, therefore, likely to be a pragmatic one, to achieve the benefits of common security and deeper integration while preserving political independence and distinctive institutions.

What might a map for strategic integration look like? A pragmatic route can be envisaged in two ways: through incremental changes to the NAFTA or through more radical institutional changes.

Deepening the NAFTA. The first mode of strategic integration recognizes that the private sector and market forces are inexorably pushing toward deeper North American integration. Governments facilitate change as pressures build to mend what no longer works. It is possible to proceed in this fashion, as has been the experience since September 11. Fix what is broken. Organize *ad hoc* working groups

on softwood lumber for another quick patch to get people back to work. Organize officials to improve border management: cooperate on preclearance of low-risk part cargo and business travelers; cooperate on screening, information exchange, intelligence, and policing. Invest in infrastructure; organize common working groups to agree to common procedures for handling goods, services, and people coming from third countries.

Incremental changes to the NAFTA would accelerate the process. The evolutionary customs union idea and external trade policies harmonized short of CVD and AD are examples of deepening the NAFTA. So is extending the NAFTA visa program for business people and professionals to technical personnel and others. Canada could reduce its corporate income tax to provide a Canadian advantage as a location for FDI. Regulatory barriers could be reduced to facilitate the development of network infrastructure in key sectors such as transportation, telecommunications, and financial services. (Such changes would free up market access for firms in both countries.) NAFTA provisions could be extended to facilitate e-commerce, and changes in intellectual property provisions and competition policy could ease knowledge-based crossborder trade and investment.[21]

Would the United States be interested? As argued earlier, the chances are small that the political champion necessary for such changes would emerge or that the US political system could sustain the focus needed to implement the many small changes these ideas imply. Another defect is that the idea of extending the NAFTA fails to address the homeland security imperative.

Canada's goal should be to achieve customs-union- and common-market-like integration without full-scale harmonization and the resulting erosion of political independence.

Pursuing the Strategic Bargain. A second mode is more likely to attract and retain the necessary political focus. Strategic integration is a package of initiatives, some of them radical ones, that Canada might take in exchange for what it wants. Canada's goal should be to achieve customs-union- and common-market-like integration without full-scale harmonization and the resulting erosion of political independence. Some elements of this package would involve institutional change; some elements would have to be negotiated, others would not. These elements are discussed below as two parts of a package: what Canada can give in exchange for what it must obtain.

Canadian Initiatives

Canada can do several things to advance the common goal of North American security. First, the bilateral border must be made more secure but, at the same time, less of an obstacle. A start along these lines has been made. The infrastructure investment, proposed in the December 2001 Canadian federal budget, promises to break some longstanding bottlenecks. The significant issues that remain include moving security measures for low-risk products and people *away* from the border through electronic means that allow registration and inspection at points of origin, rather than at road crossings, bridges, tunnels, and airports.

The second issue is security of immigration from third countries. Bilateral working groups — even common training programs — could promote such a goal

21 Harris (2001) develops some of these ideas.

while creating mutual trust in each country's objectives, policies, and operations and a basis for mutual recognition rather than harmonization. Some of these measures are also being taken.

A related issue is the handling of low-risk people who wish to cross the border. More can be done, as suggested above, to address the labor market implications of policies toward Canada-US migration. While Europeans considered these issues in the context of a common market, the North American alternative should be to facilitate movement and agree to common procedures that preserve political independence and distinctive national institutions, particularly in labor markets. Mutual recognition may be a more sensible way than harmonization to address these issues.

The third thing that Canada can do is to use its supply capabilities in a proactive way. Energy security is part of homeland security, but it tends to be overlooked as such. Securing the supply of major energy sources will become a major political issue in Washington in the near future.

Bilateral energy trade is subject to market forces, so it is reasonable to assume that private sector players will make rational decisions to augment supply when market signals are appropriate. But some supplies will take a long time to bring on stream, and market signals cannot be relied on to signify their potential social value. Thus, it is possible, especially if an offshore oil supply disruption or a copycat terrorist attack occurs, that the US political system will hammer out a policy framework in which governments, including the Canadian government, are expected to play a role. Being ready in advance would improve our chances of capturing the economic and political benefits.

For this strategy to be successful, much groundwork would have to be laid at home. Since the provinces own the natural resources, the federal government should develop a general policy framework they are willing to support. Past history suggests building this framework through quiet discussions with the provinces one at a time. Next, a federal-provincial task force should be assembled to flesh out the general framework in terms of what is possible with respect to resource development, skills training, infrastructure development, and international commitments. Canada's initiative should be introduced to Washington before a US-designed plan for North American energy security becomes more highly politicized than it already is. The purpose of this initiative should be to lay out what Canada knows it can do over, say, a ten-year period.

A federal-provincial task force should be assembled to flesh out the general framework in terms of what is possible with respect to resource development, skills training, infrastructure development, and international commitments.

The advantage of this strategy is that it could build a fund of credibility and goodwill that Canada could "spend" to obtain the objectives outlined below.[22] Such an approach could also provide a model for dealing with demand pressures on other politically sensitive natural resources, such as water. Because of these sensitivities, neither Canada nor the United States has addressed the pricing of this resource in a serious way. A bilateral working group could begin to build a base of understanding on pricing options without prejudging in any way the trade issues.

22 I am not suggesting issues linkage. Rather, a good analogy is that of a central bank's building up its credibility as an inflation fighter so that it can influence the expectations of market participants in order to stabilize economic activity. Inflation targeting is an instrument used to achieve the larger goal of economic stabilization.

Pricing strategies would, at the very least, induce conservation and could even reduce demand pressures in the long run.

The fourth issue is defense. Canada should analyze the costs of the various alternatives outlined earlier and decide how much Canadians are willing to commit to the new exigencies of North America's military defense. Recently, Canada signaled its willingness to cooperate with the US military over the next ten years on the first phase of a multiphase Joint Strike Fighter (JSF) program, the US Defense Department's largest acquisition program. This agreement will affect industrial development as well as defensive "interoperability" as it proceeds to the production phase (United States, 2002).

Canadian Objectives

Canada's objectives are, first and foremost, to reduce obstacles to the freer flow of goods, services, capital, technology, and people within the North American economic space.

Canada's objectives are, first and foremost, to reduce obstacles to the freer flow of goods, services, capital, technology, and people within the North American economic space.

The barriers to trade and investment left by the FTA and NAFTA are the ones that proved the most difficult ones to conclude because they protect inefficient sectors and touch on domestic political sensitivities. While they have not become any easier to negotiate, they are increasingly important. Situating discussion of these issues in the context of broader and deeper talks on strategic integration would be more likely to attract and retain US interest in new comprehensive negotiations. As well, Canadian and US interests overlap in certain areas.

Hart (2001) and Pastor (2001) offer lists of persistent barriers. As both authors note, agriculture remains the most difficult area to deal with because both governments — and Mexico — subsidize extensively. And neither Canada nor the United States has shown much interest in addressing the broader issue of managing farming in North America in a manner that is fair to farmers but not too costly to taxpayers. In this regard, the Europeans are far ahead in analyzing the issue (although action has been slow). Agriculture also provides a good example of the difficulties Canada would face in matching US commitments. Supply management would not survive such an initiative, nor would the trading practices of the Canadian Wheat Board. But Canadians need to realize that these programs will be under intense pressure in any new WTO round (see Hart 2001).

Canada would be particularly interested in eliminating US trade remedy laws, strengthening dispute settlement provisions, and exploring the possibilities for a common competition policy. Recurrent rounds in the softwood lumber dispute have highlighted how different regulatory regimes contribute persistent trade irritants. Resort to the WTO and NAFTA Chapter 11 in the latest round is likely to increase Canadian leverage, provided there is sufficient domestic political support to stay the course. The changing industrial structure in the US economy, shifting away from natural resources and standard technology manufacturing to high-tech goods and services, could presage declining political support for CVD and AD. The time may thus be coming to develop the common definition of permissible subsidies that has eluded Canadian negotiators. In other words, these ideas to deepen NAFTA should be folded into the larger strategic agenda.

Canada has also sought a common competition policy. Canadian and US policies here are already broadly similar, so cooperation in antitrust administration and

enforcement exists. But with rising crossborder transactions following the deregulation of key infrastructure industries, such as transportation, telecommunications, and financial services, merger control is still more complicated than it needs to be. While both countries (and Mexico as well) have said they intend to develop a common regime with appropriate legal and enforcement, progress has been modest because of national interests wishing to preserve domestic markets.

Renewed bilateral negotiations would come with a price. US interests would seek commitments that they have been unsuccessful in achieving in the past.

As indicated earlier, renewed bilateral negotiations would come with a price. US interests would seek commitments that they have been unsuccessful in achieving in the past, such as supply management and state trading practices as well as modification of Canadian-content and cultural policies and intellectual property. Nevertheless, folded into the larger unilateral initiatives, these negotiations might stand a chance, along with the judicious use of mutual recognition and harmonization.

A case could also be made for work on common institutions. Both countries should become more serious about developing structures to support and manage deeper integration.[23] One idea flowing from the earlier discussion is a joint commission to spearhead the evolutionary customs union idea. Pastor (2001) observes that the EU experience teaches us to be wary of creating new bureaucracies, but the antidote is not anarchy. Rather, it may be a few new institutions with clear mandates and possibly "sunset" provisions. He proposes NAFTA institutions on several levels. A common professional school for training customs and immigration personnel from the partner countries is a straightforward and attractive idea. Although the laws and regulations of each country would be respected, personnel would learn about each other's frameworks and develop the common knowledge and trust that are essential for working closely together professionally.[24]

Pastor (ibid.) also suggests four consultative political institutions that would be charged with developing aspects of a North American identity (that is, including Mexico) or at least the partners' greater sensitivities to the others' perspectives: a North American Commission to develop a plan for the integration and development of the continent; a parliamentary group composed of legislators from the three countries; a permanent court on trade and investment, which would be an upgraded dispute settlement mechanism; and regular meetings of cabinet ministers from each country.

In fact, a number of bilateral political consultative mechanisms already exist. Since 1982, foreign ministers have held quarterly meetings to help manage the relationship, and in 1984, the leaders of Canada and the United States agreed to hold annual summits.[25] Groups of parliamentarians hold regular bilateral meetings, although finance ministers use a more *ad hoc* mechanism. Functional consultative mechanisms, established in the late 1970s and early 1980s, exist in energy, trucking, and communications. These mechanisms are not, however, adequate to move the bilateral relationship to the strategic goal of common bilateral economic security.

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23 Indeed, this step would be common to all three proposals described in this *Commentary*.

24 One drawback to this idea, however, is that it assumes continued border inspection. Canada's goal should be to move away from the border as much inspection as possible for low-risk persons and cargo.

25 For some history on bilateral and third-party mechanisms used to manage the economic relationship, including the joint institutional approach to the East Coast fisheries, see Gotlieb (1991).

Going forward, existing mechanisms might become more formalized, and others added as necessary to manage strategic integration effectively.

The currency issue is one piece missing from this picture. Since 1988, Europeans have expended major efforts to achieve convergent macroeconomic performance, in preparation for the European Central Bank and its introduction of a common currency. In North America, the integration of Canadian and US capital markets over the past two decades has forced gradual macroeconomic convergence between the two countries and is no longer much of an issue. With the Canadian dollar at new lows, however, Canadian economists are actively debating unilateral dollarization. The United States shows no interest in the other alternative: a common North American currency with a common central banking institution accountable to both the Canadian Parliament and the US Congress. From Canada's perspective, without political institutions and other supporting and buffering mechanisms, unilateral dollarization, however *ad hoc* it might appear, could take us, unintentionally, far down the road to harmonization. Yet, in the absence of US interest, I conclude that, although a common North American currency is not out of the realm of possibility in the distant future, the necessary progression to a common institution is not a realistic step to contemplate at this time.

Summary

In sum, my suggestion of strategic integration has several characteristics. First, the Canadian initiatives outlined above are designed to meet the security interests of the United States in exchange for its agreement to some customs-union- and common-market-like arrangements. The goal is a pragmatic one: to do away with costly or redundant rules and regulations and to free up bilateral flows of people, capital, and technology (as well as goods and services) without undermining distinctive national institutions.

Second, deeper integration would require more and broader political and functional cooperative mechanisms. A persistent concern is that the asymmetry of the economic relationship will lead to harmonization. But once such discussions began, the United States would become an equal partner. Harmonization may be proposed, but the other partner has a say in whether the proposal is accepted.

Third, achieving the common goal of North American economic security would serve the common interest by increasing the efficiency and productivity of both economies, and Canada's interest by preserving and enhancing access to the US market.

Conclusion

Canada will attract US attention to Canada's economic concerns only by initiating a joint strategy to pursue a Big Idea.

The United States is currently more open than usual to its closest neighbors as it searches for ways to promote its objectives for homeland and energy security. The thesis in this overview *Commentary* is that Canada will attract US attention to Canada's economic concerns only by initiating a joint strategy to pursue a Big Idea. Three factors should affect our choice of how we manage an agenda for deeper integration. We should think about Canadian sovereignty in terms of *exercising* it, not guarding it; we should proceed bilaterally but be open to including Mexico when it makes sense; and we should propose a common strategy to attract US interest.

In pursuing this agenda, our goal should be to achieve the benefits of a customs union or a common market as far as possible without the harmonization that would undermine political independence.

There are at least three Big Ideas for shaping the future of the North American economic space. "The Border Papers" that the C.D. Howe Institute will publish in the months ahead will examine in more depth the interrelationships between economic and security issues and ideas. This overview sketches these routes to deeper integration and some of their implications.

- *A customs union* could be achieved by alternative routes, each of which would have different impact on Canadian political independence and institutions:
  - Negotiate a common tariff, leaving commercial policies intact.
  - Negotiate a common trade policy.
  - Negotiate sectoral customs unions, like the already-existing customs union in computers and related products, as tariffs converge in other sectors.
- *A common market* is also possible, but it would present difficulties of preserving political independence, given the common institutions and policies that are necessary to create single markets in the common area.
- *A strategic bargain* is a pragmatic route that would take account of North American uniqueness and combine Canadian security initiatives with customs-union- and common-market-like reductions in the impediments to trade, investment, and the movement of people. It would use formal negotiations only when necessary and rely in a pragmatic fashion on mechanisms such as mutual recognition and selective harmonization to achieve convergence.

The advantage of a Big Idea lies in setting a strategic objective and proposing some large initiatives in which linkages and tradeoffs are possible that would not be available in ad hoc, *stand-alone efforts.*

Only a Big Idea is likely to attract US attention. None would be achieved overnight, but the advantage lies in setting a strategic objective and proposing some large initiatives in which linkages and tradeoffs are possible that would not be available in *ad hoc*, stand-alone efforts. Finally, in dealing with the US political system, a well-known aphorism is worth recalling: "If you don't know where you are going, you may end up somewhere else."

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